

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS—(Continued)

YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

for certain costs and cost of capital in connection with these services. TCG is also in the process of negotiating a market based agreement for the provision of telephony services for TCI in multiple dwelling units at various locations. At December 31, 1997 and 1996, the amounts due to TCG for this reimbursement were \$1.0 million and \$1.1 million, respectively, and are included in accounts receivable—related parties. TCG has entered into an agreement with Comcast to support a Comcast residential service offering to be conducted in Maryland and Florida.

TCG also provides management services to certain affiliates of Cox under three Operator Managed Ventures Services Agreements, including billing services, network monitoring and accounts receivable functions. Under the terms of the agreements, TCG retains 8% of the collected revenues from Cox customers as a royalty fee. Royalty fees recorded from Cox were approximately \$0.6 million, \$0.3 million and \$0.1 million for the years ended December 31, 1997, 1996 and 1995, respectively. Included in accounts receivable—trade are approximately \$1.0 million and \$0.4 million at December 31, 1997 and 1996, respectively, for amounts owed by Cox customers. At December 31, 1997 and 1996, the amounts due to Cox affiliates under the agreements were \$1.7 million and \$1.1 million, respectively.

In 1997 and 1996, TCG purchased cable on behalf of certain of the Cable Stockholders, which it then sold to them at cost. The amount receivable from the owners was \$1.1 million and \$1.5 million as of December 31, 1997 and 1996, respectively.

Sprint PCS, a partnership owned 60% by TCI, Comcast and Cox, entered into service arrangements, preliminary agreements or letters of intent with a number of wholly-owned subsidiaries of TCG providing for the construction of special facilities and the provision of services to Sprint PCS by TCG. TCG and Sprint PCS continued this service relationship throughout 1997. The amount receivable from Sprint PCS at December 31, 1997 and 1996, respectively, was \$1.6 million and \$0.3 million.

In connection with the management of the Local Market Partnerships, TCG entered into management services agreements. Under the terms of such agreements, TCG provided certain operating and administrative services to such entities, for which it earned management fees. Management fees earned were approximately \$0, \$21.8 million and \$29.6 million in 1997, 1996 and 1995, respectively. After July 2, 1996, such management fee revenue is no longer recorded because the previously unconsolidated partnerships are now consolidated.

Related to the acquisition of KCFN, TCG is liable to fund the operations until the closing. Such liability for KCFN as of December 31, 1997 is \$2.3 million which is included in accounts payable and accrued liabilities. The liability associated with the acquisition of KCFN of approximately \$55 million is included in accounts payable and accrued liabilities.

11. Commitments and Contingencies

Operating Leases

Under the terms of contracts with various parties, TCG is obligated to pay franchise fees, office rents, node rents and rights-of-way fees in connection with its fiber optic network through 2022. These contracts provide for certain scheduled increases and for possible escalation of basic rentals based on a change in the cost of living or on other factors. TCG expects to enter into other contracts for additional franchise fees, office rents, node rents, rights-of-way, facilities, equipment, and maintenance services in the future.

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YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

A summary of such fixed commitments at December 31, 1997 is as follows (in thousands):

<u>Years</u>	<u>Amount</u>
1998	\$ 34,079
1999	32,286
2000	29,986
2001	27,908
2002	25,723
Thereafter	65,814
Total	<u>\$215,796</u>

Rent expense under operating leases was approximately \$31.4 million, \$18.0 million and \$11.8 million for the years ended December 31, 1997, 1996 and 1995, respectively.

Capital Leases

Communications network includes assets acquired under capital leases of approximately \$154.1 million and \$114.1 million (including approximately \$111.6 million and \$96.0 million with related parties) at December 31, 1997, and 1996, respectively. The related accumulated depreciation and amortization was approximately \$18.9 million and \$12.1 million, respectively.

The following is a schedule, by year, of future minimum payments under the leases, together with the present value of the net minimum payments as of December 31, 1997 (in thousands):

<u>Years</u>	<u>Amount</u>
1998	\$38,218
1999	12,545
2000	4,860
2001	844
2002	534
Thereafter	4,130
Total minimum lease payments	61,131
Less amount representing interest	8,312
Total obligations under capital leases	<u>\$52,819</u>

Retention Incentive

As part of the AT&T Merger, TCG has offered a retention incentive compensation package to all employees as of January 8, 1998. These amounts are payable in four installments, the closing date of the proposed AT&T Merger, the first anniversary of the closing date, the second anniversary of the closing date and thereafter to all employees still employed at TCG. Such amounts are currently estimated at \$14.4 million, \$14.4 million, \$10.4 million and \$.8 million, respectively. There are no assurances that the AT&T Merger will be consummated.

Revenue Sharing Agreements

Teleport Communications is subject to a revenue sharing agreement with The Port Authority of New York and New Jersey (the "Port Authority"). Based on the agreement, Teleport Communications is obligated to pay to the Port Authority 5% of its gross revenues, and may be required to pay a "net return rental fee," as defined,

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YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

to the extent its cumulative net return exceeds the entitlement amount. For the years ended December 31, 1997, 1996 and 1995 the payments made were \$300,000 in each year. Teleport Communications is required to remit to the Port Authority a minimum payment currently equal to \$300,000 annually.

Teleport Communications entered into a 15-year franchise agreement with the City of New York during 1994, which among other things, requires a payment based on certain gross revenues, as defined in the agreement. The franchise provides for the payment of 10% of certain gross revenues in 1995 and 1996, 6% in 1997 and 5% thereafter, all subject to certain setoffs, reductions and adjustments. The franchise also provides that commencing with calendar year 1995, payment to the City will be no less than \$200,000 per year. For the years ended December 31, 1997, 1996 and 1995 the payments made to the City under the franchise were \$1.1 million, \$0.8 million and \$0.3 million, respectively.

Litigation

In April 1997, a complaint seeking damages in an unspecified amount was filed against the Company in the Circuit Court of Cook County, Illinois by two former customers of the Company and an alleged class purporting to consist of investors in one of the customers, alleging fraud and breach of contract. The initial complaint was dismissed in September 1997 and an amended complaint was refiled by the plaintiffs in October 1997. The Company, upon consultation with counsel, believes that the allegations are without merit and that it possess meritorious counterclaims for damages arising from breach of contract. The Company additionally believes that any costs arising from this lawsuit will not have a material adverse effect on its financial condition, results of operations or cash flows.

On December 16, 1997, prior to public announcement of the AT&T Merger, an action was filed by one TCG public stockholder in the Delaware Court of Chancery against TCG, TCG's directors and the Cable Stockholders. The plaintiff's complaint alleges that, based on public reports, TCG's directors, management and controlling stockholders were negotiating the sale of TCG to AT&T on a preferential basis. This sale on a preferential basis, the complaint alleges, would offer little or no premium over the current market price of TCG Class A Common Stock and is therefore unfair and inadequate to TCG's public stockholders. The plaintiff seeks to enjoin the merger of TCG and AT&T or, alternatively, to rescind the transaction and/or recover damages in the event that the transaction is consummated. The complaint seeks to have the action certified for class action status and to appoint the plaintiff as the class representative.

On January 12, 1998, an action was filed by two TCG public stockholders in the Delaware Court of Chancery against TCG, certain TCG directors and officers, the Cable Stockholders and AT&T. The complaint alleges that the exchange ratio in the AT&T Merger represents an inadequate premium for stockholders of TCG Class A Common Stock. The complaint further alleges that the actions of the TCG directors, officers and Cable Stockholders in connection with the AT&T Merger constitute a breach of various fiduciary duties owed to the stockholders of TCG Class A Common Stock. The plaintiffs seek to enjoin the merger of TCG and AT&T or, alternatively, to rescind the transaction and/or recover damages in the event that the transaction is consummated. The complaint seeks to have the action certified for class action status and to appoint the plaintiffs as the class representatives.

On January 28, 1998, an action was filed by a TCG public stockholder in the Delaware Court of Chancery against TCG, certain TCG directors and officers, and the Cable Stockholders. The complaint alleges that the exchange ratio in the AT&T Merger represents an inadequate premium for stockholders of TCG Class A Common Stock. The complaint further alleges that the actions of the TCG directors, officers and Cable Stockholders in connection with the AT&T Merger constitute a breach of various duties owed to the stockholders

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YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

of TCG Class A Common Stock. The plaintiffs seek to enjoin the merger of TCG and AT&T or, alternatively, to rescind the transaction and/or recover damages and fees in the event that the transaction is consummated. The complaint seeks to have the action certified for class action status and to appoint the plaintiff as the class representative.

Plaintiffs' counsel in the above three putative stockholder class action proceedings have agreed (i) to defer the obligation of the defendants to answer the actions and (ii) to consolidate the actions by filing an amended consolidated complaint. As of the end of February 1998, the amended consolidated complaint had not been filed. The Company believes that these proceedings, individually and in the aggregate, are without merit and that any associated costs will not have a material adverse effect on TCG's financial condition, results of operations or cash flows.

In the ordinary course of business, TCG is involved in various litigation and regulatory matters, proceedings and claims. In the opinion of TCG's management, after consultation with counsel, the outcome of such proceedings will not have a materially adverse effect on TCG's financial position, results of operations or cash flows.

12. Supplemental Disclosure of Cash Flow Information

Cash paid for interest and non-cash investing and financing activities for the years ended December 31, 1997, 1996 and 1995 were as follows (in thousands):

	1997	1996	1995
Cash paid during the year for interest	\$ 43,008	\$ 7,818	\$ 8,675
Fixed assets acquired under capital leases	\$ 38,244	\$ 14,034	\$15,151
Compensation paid in stock	\$ 4,772	—	—
Rights-of-way obtained in exchange for cable installation	\$ —	\$ —	\$ 1,330
Conversion of subordinated debt to parents plus accrued interest	\$ —	\$263,602	\$ —
Conversion and stock split of \$1 par value common stock to 139,250,370 shares of Class B Common Stock as part of the TCG Reorganization	\$ —	\$213,099	\$ —
Acquisition of subsidiaries	\$131,246	\$ —	\$ —
Cash acquired in acquisitions	1,203	—	—
Common stock issued	123,334	—	—
	124,537	—	—
Cash paid to acquire subsidiaries	\$ 6,709	\$ —	\$ —

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS—(Continued)

YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

13. Selected Quarterly Information (Unaudited)

Summarized below is quarterly financial information for the years ended December 31, 1997 and 1996 (in thousands, except per share amounts):

<u>1997</u>	<u>1st Quarter Consolidated</u>	<u>2nd Quarter Consolidated</u>	<u>3rd Quarter Consolidated</u>	<u>4th Quarter Consolidated</u>	<u>Total</u>
Revenues	\$ 96,844	\$115,664	\$131,406	\$150,390	\$ 494,304
Net loss	(45,028)	(51,332)	(53,784)	(72,523)	(222,667)
Loss per common share	\$ (0.28)	\$ (0.31)	\$ (0.33)	\$ (.42)	\$ (1.34)
<u>1996</u>	<u>Combined</u>	<u>Combined</u>	<u>Consolidated</u>	<u>Consolidated</u>	<u>Total</u>
Revenues	\$ 50,435	\$ 57,087	\$ 72,749	\$ 87,398	\$ 267,669
Net loss	(18,693)	(19,743)	(33,705)	(42,709)	(114,850)
Loss per common share	\$ (0.25)	\$ (0.27)	\$ (0.21)	\$ (0.27)	\$ (1.00)

14. Subsequent Events (Unaudited)

On March 11, 1998, for reasons beyond the control of both parties, which made it impossible to conclude the USW Merger prior to the March 31, 1998 termination date, ACC and USW agreed to a mutual termination of the USW Merger Agreement.

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Shareholders of ACC Corp.:

We have audited the accompanying consolidated balance sheets of ACC Corp. (a Delaware corporation) and subsidiaries as of December 31, 1997 and 1996, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 1997. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ACC Corp. and subsidiaries as of December 31, 1997 and 1996, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1997 in conformity with generally accepted accounting principles.

ARTHUR ANDERSEN LLP

Rochester, New York,
February 3, 1998, except for the matter
described in the second paragraph of Note 10,
as to which the date is March 11, 1998.

ACC CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Amounts in 000s, except share data)

	For the Years Ended December 31,		
	1997	1996	1995
Revenue:			
Toll revenue	\$ 327,490	\$ 282,497	\$ 175,269
Local service and other	45,123	26,270	13,597
Total revenue	372,613	308,767	188,866
Network costs	218,361	193,599	114,841
Gross profit	154,252	115,168	74,025
Other Operating Expenses:			
Depreciation and amortization	23,712	16,433	11,614
Selling expenses	50,958	34,072	21,617
General and administrative	60,069	50,439	39,248
Management restructuring	—	—	1,328
Total other operating expenses	134,739	100,944	73,807
Income from operations	19,513	14,224	218
Other Income (Expense):			
Interest income	215	1,151	198
Interest expense	(3,729)	(5,025)	(5,131)
Merger costs	(4,970)	—	—
Foreign exchange gain (loss)	(162)	509	(110)
Total other income (expense)	(8,646)	(3,365)	(5,043)
Income (loss) from operations before provision for income taxes and minority interest	10,867	10,859	(4,825)
Provision for income taxes	476	2,185	396
Minority interest in earnings of consolidated subsidiary	—	(909)	(133)
Net Income (Loss)	10,391	7,765	(5,354)
Less Series A Preferred Stock dividend	—	(972)	(401)
Less Series A Preferred Stock accretion	—	(1,509)	(139)
Net income (loss) applicable to Common Stock	\$ 10,391	\$ 5,284	\$ (5,894)
Net income (loss) per common share—basic	\$ 0.62	\$ 0.37	\$ (0.52)
Net income (loss) per common share—diluted	\$ 0.59	\$ 0.34	\$ (0.52)
Weighted average shares outstanding—basic	16,839,039	14,463,728	11,358,693
Weighted average shares outstanding—diluted	17,690,223	15,540,115	11,358,693

The accompanying notes to consolidated financial statements are an integral part of these statements.

ACC CORP. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Amounts in 000s, except share and per share data)

	December 31, 1997	December 31, 1996
Current Assets:		
Cash and cash equivalents	\$ 3,988	\$ 2,035
Accounts receivable, net of allowance for doubtful accounts of \$5,291 in 1997 and \$3,795 in 1996	76,909	51,474
Other receivables	3,732	3,792
Prepaid expenses and other assets	7,718	4,632
Total Current Assets	92,347	61,933
Property, Plant, and Equipment:		
At cost	189,249	119,398
Less—accumulated depreciation and amortization	(53,523)	(38,946)
Total Property, Plant, and Equipment	135,726	80,452
Other Assets:		
Goodwill and customer base, net	73,607	50,629
Deferred installation costs, net	5,668	4,312
Other	12,270	6,705
Total Other Assets	91,545	61,646
Total Assets	\$319,618	\$204,031
Current Liabilities:		
Notes payable	1,000	730
Current maturities of long-term debt	2,853	3,521
Accounts payable	23,374	15,351
Accrued network costs	35,973	22,908
Other accrued expenses	26,593	34,884
Total Current Liabilities	89,793	77,394
Deferred income taxes	1,888	2,767
Long-term debt	90,221	6,007
Shareholders' Equity:		
Preferred Stock, \$1.00 par value, Authorized—1,990,000 shares; Issued—no shares	—	—
Class A Common Stock, \$.015 par value, Authorized—50,000,000 shares; Issued—18,297,145 in 1997 and 17,684,361 in 1996	275	265
Class B Common Stock, \$.015 par value, Authorized—25,000,000 shares; Issued—no shares	—	—
Capital in excess of par value	126,707	116,878
Cumulative translation adjustment	(1,739)	(1,362)
Retained earnings (deficit)	14,083	3,692
	139,326	119,473
Less—Treasury stock, at cost (1,089,884 shares)	(1,610)	(1,610)
Total Shareholders' Equity	137,716	117,863
Total Liabilities and Shareholders' Equity	\$319,618	\$204,031

The accompanying notes to consolidated financial statements are an integral part of these balance sheets.

ACC CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Amounts in 000s)

	For the Years ended December 31,		
	1997	1996	1995
Cash Flows from Operating Activities:			
Net income (loss)	\$ 10,391	\$ 7,765	\$ (5,354)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	23,712	16,433	11,614
Deferred income taxes	(930)	3,110	609
Minority interest in earnings (loss) of consolidated subsidiary	—	909	133
Unrealized foreign exchange (gain) loss	(121)	(758)	180
Amortization of deferred financing costs	629	425	263
(Increase) Decrease in Assets:			
Accounts receivable, net	(22,442)	(11,212)	(17,437)
Other receivables	87	1,955	1,782
Prepaid expenses and other assets	(8,289)	(2,282)	(1,057)
Deferred installation costs	(3,884)	(2,631)	(2,983)
Other	—	(148)	846
Increase (Decrease) in Liabilities:			
Accounts payable	4,417	7,511	(7,013)
Accrued network costs	9,627	(5,837)	17,824
Other accrued expenses	(9,506)	9,008	4,560
Net cash provided by operating activities	3,691	24,248	3,967
Cash Flows from Investing Activities:			
Capital expenditures, net	(68,479)	(33,030)	(12,424)
Repurchase of minority interest	—	(32,092)	—
Payment for purchase of subsidiaries, net of cash acquired	(21,958)	—	(2,313)
Acquisition of customer base	(840)	(2,620)	(557)
Net cash used in investing activities	(91,277)	(67,742)	(15,294)
Cash Flows from Financing Activities:			
Borrowings under lines of credit and notes payable	211,673	26,375	113,602
Repayments under lines of credit and notes payable	(123,145)	(48,676)	(119,204)
Repayment of long-term debt, other than lines of credit	(10,414)	(3,704)	(3,078)
Proceeds from issuance of common stock	9,839	72,669	13,261
Proceeds from issuance of convertible debt	—	—	10,000
Financing costs	(1,805)	(495)	(2,876)
Dividends paid	—	—	(451)
Net cash provided by financing activities	86,148	46,169	11,254
Effect of exchange rate changes on cash	3,391	(1,158)	(430)
Net increase (decrease) in cash	1,953	1,517	(503)
Cash and cash equivalents at beginning of year	2,035	518	1,021
Cash and cash equivalents at end of year	\$ 3,988	\$ 2,035	\$ 518
Supplemental Disclosures of Cash Flow Information:			
Cash paid during the year for:			
Interest	\$ 4,122	\$ 2,840	\$ 4,146
Income taxes, net of refunds	\$ 884	\$ 1,808	\$ 203
Supplemental Schedule of Noncash Investing and Financing Activities:			
Equipment purchased through capital leases	\$ 2,333	—	\$ 7,389
Fair value of assets acquired	\$ 36,061	\$ 5,136	\$ 10,800
Less—cash paid at acquisition date, net of cash acquired	(21,958)	(3,001)	(1,500)
Less—short term notes payable	—	—	(2,966)
Liabilities assumed	\$ 14,103	\$ 2,135	\$ 6,334
Other assets purchased with long-term debt	\$ —	\$ 2,775	—
Conversion of convertible debt to Series A Preferred Stock	—	—	\$ 10,000
Conversion of Series A Preferred Stock to Class A Common Stock, including cumulative dividends and accretion	—	\$ 11,929	—

The accompanying notes to consolidated financial statements are an integral part of these statements.

ACC CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 1997, 1996, AND 1995
(Amounts in 000s, except share and per share data)

	<u>Class A Common Stock</u>		<u>Capital in</u>	<u>Cumulative</u>	<u>Retained</u>	<u>Treasury</u>	<u>Total</u>
	<u>Shares</u>	<u>Amount</u>	<u>Excess of</u> <u>Par Value</u>	<u>Translation</u> <u>Adjustment</u>	<u>Earnings</u> <u>(Deficit)</u>	<u>Stock</u>	
Balance, December 31, 1994	11,478,902	\$172	\$ 20,013	\$(1,013)	\$ 1,524	\$(1,610)	\$ 19,086
Stock Options exercised	50,287	1	479	—	—	—	480
Sale of Stock	1,237,500	18	11,078	—	—	—	11,096
Employee stock purchase plan shares issued ..	35,450	1	296	—	—	—	297
Stock warrants exercised	123,750	2	1,186	—	—	—	1,188
Stock warrants issued	—	—	200	—	—	—	200
Accretion of Series A Preferred Stock	—	—	(139)	—	—	—	(139)
Series A Preferred Stock dividends	—	—	(401)	—	—	—	(401)
Acceleration of stock option vesting due to termination	—	—	134	—	—	—	134
Dividends (\$.02 per common share)	—	—	—	—	(243)	—	(243)
Cumulative translation adjustment	—	—	—	63	—	—	63
Net loss	—	—	—	—	(5,354)	—	(5,354)
Balance, December 31, 1995	12,925,889	\$194	\$ 32,846	\$(950)	\$(4,073)	\$(1,610)	\$ 26,407
Stock Options exercised	587,881	9	4,712	—	—	—	4,721
Class A Common Stock offerings	3,018,750	45	62,849	—	—	—	62,894
Conversion of Series A Preferred Stock	937,500	14	11,915	—	—	—	11,929
Employee stock purchase plan shares issued ..	19,341	—	343	—	—	—	343
Stock warrants exercised	195,000	3	2,077	—	—	—	2,080
Increase in investment in Canadian subsidiary	—	—	1,254	—	—	—	1,254
Disqualifying dispositions	—	—	3,000	—	—	—	3,000
Accretion of Series A Preferred Stock	—	—	(1,509)	—	—	—	(1,509)
Series A Preferred Stock dividends	—	—	(972)	—	—	—	(972)
Acceleration of stock option vesting due to termination	—	—	206	—	—	—	206
Stock incentive rights issued	—	—	157	—	—	—	157
Cumulative translation adjustment	—	—	—	(412)	—	—	(412)
Net income	—	—	—	—	7,765	—	7,765
Balance, December 31, 1996	17,684,361	\$265	\$116,878	\$(1,362)	\$3,692	\$(1,610)	\$117,863
Stock Options exercised	573,195	9	7,241	—	—	—	7,250
Employee stock purchase plan shares issued ..	28,339	1	686	—	—	—	687
Stock warrants exercised	11,250	—	140	—	—	—	140
Disqualifying dispositions	—	—	1,200	—	—	—	1,200
Stock incentive rights issued	—	—	562	—	—	—	562
Cumulative translation adjustment	—	—	—	(377)	—	—	(377)
Net income	—	—	—	—	10,391	—	10,391
Balance, December 31, 1997	18,297,145	\$275	\$126,707	\$(1,739)	\$14,083	\$(1,610)	\$137,716

The accompanying notes to consolidated financial statements are an integral part of these statements.

ACC CORP. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

A. Principles of Consolidation:

The consolidated financial statements include all accounts of ACC Corp. (a Delaware corporation) and its direct and indirect subsidiaries ("the Company" or "ACC"). Principal operating subsidiaries include: ACC TeleCom ("ACC US"), ACC TelEnterprises Ltd. ("ACC Canada"), ACC Long Distance UK Ltd. ("ACC UK"), and ACC Telekommunikation GmbH ("ACC Germany"). All operating subsidiaries are wholly-owned. All significant intercompany accounts and transactions have been eliminated.

The accompanying consolidated financial statements reflect the results of operations of acquired companies since their respective acquisition dates.

B. Minority Interest:

On July 6, 1993, the Company's then wholly-owned Canadian subsidiary, ACC TelEnterprises Ltd., completed an initial public offering of 2 million common shares for Cdn. \$11.00 per share. The Company received net proceeds of approximately Cdn. \$20.7 million after underwriters' fees and before other direct costs of the offering of Cdn. \$1.3 million. As a result of the offering, ACC Corp.'s ownership was reduced to approximately 70%.

Minority interest represents the non-Company owned shareholder interest in ACC TelEnterprises Ltd.'s equity primarily resulting from the 1993 public offering. In the third quarter of 1996, the Company made a cash tender offer of Cdn. \$21.50 per share for the repurchase of the minority-held shares. In September 1996, the tender offer was approved by the Boards of Directors of both companies and, in the fourth quarter of 1996, approximately 1.9 million of the outstanding shares, representing approximately 81.5% of the minority interest, were tendered and purchased by the Company for Cdn. \$40.4 million (US \$29.5 million), increasing the Company's ownership in ACC Canada to 93.9% as of December 31, 1996. As fewer than 90% of the publicly held shares were deposited under the tender offer, the Company formed a subsidiary for the purpose of acquiring the remaining minority interest of ACC Canada. Prior to December 31, 1996, the shareholders of ACC Canada approved the amalgamation of ACC Canada and the new subsidiary. The amalgamation was effective January 1, 1997 and the remaining minority interest shares of ACC Canada were replaced with shares of the new subsidiary. These shares were purchased by the new subsidiary at a price of Cdn. \$21.50 per share (see Note 1 G).

C. Revenue:

The Company records as long distance toll revenue the amount of communications services rendered, as measured by the related minutes of toll traffic processed or flat-rate services billed, after deducting an estimate of the traffic or services which will neither be billed nor collected. Local service and other revenue represents revenue derived from the provision of local exchange services, including local dial tone, direct access lines, and monthly subscription fees, as well as data services, and is recorded as the services are provided and billed. Revenue from prepaid calling cards is recognized when received.

D. Other Receivables:

Other receivables at December 31, 1997 consist of receivables primarily related to taxes receivable (approximately \$1.7 million), amounts due from counterparties under cross-currency rate swap agreements (approximately \$1.5 million), and other individually nominal, miscellaneous receivables (approximately \$0.5 million). Other receivables at December 31, 1996 consist of receivables primarily related to taxes receivable (approximately \$1.8 million), the financing of university projects (approximately \$0.5 million), officer notes receivable (approximately \$0.4 million), and other individually nominal, miscellaneous receivables (approximately \$1.1 million).

ACC CORP. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

E. Property, Plant, and Equipment:

The Company's property, plant, and equipment consisted of the following at December 31, 1997 and 1996 (amounts in 000s):

	<u>1997</u>	<u>1996</u>
Equipment	\$126,661	\$ 90,257
Computer software and software licenses	16,064	12,682
Other	46,524	16,459
Total	<u>\$189,249</u>	<u>\$119,398</u>

Other property, plant and equipment includes accumulated costs for uncompleted projects in progress of approximately \$36.7 million as of December 31, 1997, and \$9.5 million as of December 31, 1996. These costs primarily relate to projects to acquire, install and make operational switch and transmission equipment, and major software systems. Projects in progress at December 31, 1997 are expected to be completed in the first half of 1998.

Depreciation and amortization of property, plant, and equipment is computed using the straight-line method over the following estimated useful lives:

Leasehold improvements	Life of lease
Equipment, including assets under capital leases	2 to 15 years
Computer software and software licenses	5 to 7 years
Office equipment and fixtures	3 to 10 years
Vehicles	3 years

Equipment and computer software include assets financed under capital lease obligations. A summary of these assets at December 31, 1997 and 1996 is as follows (amounts in 000s):

	<u>1997</u>	<u>1996</u>
Cost	\$10,566	\$14,336
Less—accumulated amortization	(6,032)	(6,194)
Total, net	<u>\$ 4,534</u>	<u>\$ 8,142</u>

Betterments, renewals, and extraordinary repairs that extend the life of the asset are capitalized; other repairs and maintenance are expensed. The cost and accumulated depreciation applicable to assets retired are removed from the accounts and the gain or loss on disposition is recognized in income.

The Company reviews long-lived assets to be held and used, including related goodwill, for possible impairment when events or changes in circumstances indicate that their carrying amounts may not be recoverable. If an impairment exists, a loss is recognized to the extent the carrying value of the asset exceeds its fair value.

F. Deferred Costs:

Costs incurred for the installation of direct access lines are amortized on a straight-line basis over the estimated useful life of three to ten years. Accumulated amortization of deferred installation costs totaled approximately \$8.6 million and \$6.4 million at December 31, 1997 and 1996, respectively.

G. Goodwill and Customer Base:

Each of the Company's acquisitions have been accounted for as purchases and, accordingly, the purchase prices were allocated to the assets and liabilities of the acquired companies based on their fair values at the acquisition date.

ACC CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

As of August 1, 1995, ACC TelEnterprises Ltd. acquired Metrowide Communications ("Metrowide"). Metrowide, based in Toronto, Canada, provides local and long distance services to customers based in Ontario and Quebec, Canada. The results of operations of Metrowide are included in the accompanying financial statements since the date of acquisition. The total cost of the acquisition was Cdn. \$15.1 million (US \$11.0 million) including Cdn. \$9.1 million (US \$6.6 million) of liabilities assumed. All payments related to the purchase price of the acquisition were made as of December 31, 1996.

In May 1996, ACC Canada purchased certain assets and assumed certain liabilities of Internet Canada Corp., a company based in Toronto, Canada, which is engaged in the business of providing Internet access and website design and development. The purchase price was Cdn. \$5.2 million. All payments related to the purchase price of the acquisition were made as of December 31, 1996.

Goodwill of Cdn. \$11.1 million (US \$8.1 million) associated with the ACC TelEnterprises Ltd. asset purchases is being amortized over 20 years.

Also in 1996, as described above, the Company repurchased a significant portion of the minority interest in ACC TelEnterprises Ltd. The minority-held shares were purchased for Cdn. \$21.50 per share, which represented a premium over the book value of the shares. The total amount paid in 1996 for this acquisition was Cdn. \$43.7 million (US \$32.0 million). In 1997, the remaining 6.1% interest was acquired for Cdn. \$9.0 million (US \$6.6 million). The resulting goodwill, approximately Cdn. \$48.0 million (US \$35.0 million), will be amortized over a 40 year life.

The following unaudited pro forma summary gives effect to the acquisition of Internet Canada Corp. and the acquisition of the minority interest of ACC Canada as if they had occurred at the beginning of 1995, after giving effect to certain pro forma adjustments, including elimination of the minority interest in earnings of ACC Canada, amortization of the goodwill and customer base acquired in the acquisitions, interest expense on the acquisition financing, and related income tax effects. This unaudited pro forma financial information is presented for informational purposes only and may not be indicative of the results of operations as they would have been if the acquisitions had occurred at the beginning of 1995, nor is it necessarily indicative of the results of operations which may occur in the future. Anticipated efficiencies from the combination of Internet Canada and ACC Canada are not fully determinable and therefore have been excluded from the amounts included in the pro forma summary below (amounts in 000s, except share and per share data).

	Years ended December 31,	
	1996	1995
	(Unaudited)	
Total revenue	\$308,767	\$188,866
Income (loss) from operations	13,175	(1,066)
Net income (loss)	5,372	(8,659)
Share data:		
Net income (loss)	\$ 0.34	\$ (0.74)
Net income (loss) applicable to common stock	\$ 0.18	\$ (0.79)
Weighted average shares outstanding	15,641	11,685

During 1997, the Company consummated several business combinations, all accounted for as purchases, as follows:

ACC UK acquired Transphone International Ltd. ("Transphone"), a long distance reseller based in London, U.K. The results of operations of Transphone are reflected in the 1997 consolidated results of operations effective June 1, 1997. Transphone reported 1.5 million pounds sterling (US \$2.4 million) in annual revenues for the calendar year ended December 31, 1996.

ACC CORP. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

ACC UK acquired United Telecom Ltd. ("UT"), a pre-paid calling card and long distance services provider based in London, UK. The results of operations of UT are reflected in 1997 consolidated results of operations effective July 1, 1997. UT reported 2.8 million pounds sterling (US \$4.5 million) in annual revenue for the fiscal year ended April 30, 1997.

ACC US acquired VISTA International Communications Inc. ("VISTA"), a privately held switch-based long distance provider based in Mount Arlington, New Jersey. VISTA provides services to small-to-medium sized commercial customers in the Northeastern US, with concentrations primarily in New Jersey and Pennsylvania. The results of operations of VISTA are reflected in the 1997 consolidated results of operations effective August 1, 1997. VISTA reported \$10 million in annual revenue for the calendar year ended December 31, 1996.

ACC Germany acquired all the interests of Telenational Communications Deutschland Limited Partnership ("TNC"), a privately held telecommunications services provider based in Hamburg, Germany. TNC was a supplier of prepaid calling cards, and developed affinity programs with large commercial customers. The results of operations of TNC are reflected in the 1997 consolidated results of operations effective July 1, 1997. TNC reported annualized revenue of German Deutsche Marks (DM) 7.8 million (US \$4.3 million).

The aggregate amount paid for these acquisitions was US \$22.9 million. The estimated fair value of assets acquired (including intangibles) was US \$37.0 million, and liabilities assumed was US \$14.1 million. Goodwill associated with these acquisitions was US \$21.6 million, and is being amortized from 20 to 40 years. Customer base intangibles associated with these acquisitions was US \$7.1 million, and is being amortized from 5 to 7 years.

Accumulated amortization of all goodwill approximated US \$2.3 million and \$0.5 million at December 31, 1997 and 1996, respectively. The Company amortizes acquired customer bases on a straight-line basis over five to seven years. Accumulated amortization of customer base totaled approximately \$8.3 million and \$5.5 million at December 31, 1997 and 1996, respectively.

H. Earnings Per Share:

During 1997, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 128, "Earnings Per Share". Adoption of this Statement did not have a material effect on the reported earnings per share of the Company. All prior-period earnings per share data have been restated to conform to the provisions of the Statement.

The following table reconciles the numerators and denominators of basic and diluted earnings per share (amounts in 000s, except share and per share data):

	For the Year Ended December 31, 1997		
	Income (Numerator)	Shares (Denominator)	Per-Share Amount
Basic EPS			
Net income applicable to common stock	\$ 10,391	16,839,039	\$ 0.62
Effect of dilutive securities			
Stock options and warrants	—	851,184	
Diluted EPS			
Net income applicable to common stock	\$ 10,391	17,690,223	\$ 0.59

ACC CORP. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

	For the Year Ended December 31, 1996		
	Income (Numerator)	Shares (Denominator)	Per-Share Amount
Net income	\$ 7,765		
Less: Series A Preferred Stock dividend	(972)		
Series A Preferred Stock accretion	<u>(1,509)</u>		
Basic EPS			
Net income applicable to common stock	5,284	14,463,728	<u>\$0.37</u>
Effect of dilutive securities			
Stock options and warrants	<u>—</u>	<u>1,076,387</u>	
Diluted EPS			
Net income applicable to common stock	<u>5,284</u>	<u>15,540,115</u>	<u>\$0.34</u>

No reconciliation is provided for 1995 as the effect would be anti-dilutive. All share information noted above represents the weighted-average number of shares during the period. All references to common shares have been retroactively restated to reflect an August 8, 1996 three-for-two stock dividend.

I. Foreign Currency Translation:

Assets and liabilities of ACC Canada, ACC UK and ACC Germany, operating in Canada, the United Kingdom and Germany, respectively, are translated into US dollars using the exchange rates in effect at the balance sheet date. Results of operations are translated using the exchange rate at the date of the transaction. The effects of exchange rate fluctuations on translating foreign currency assets and liabilities into US dollars are included as part of the cumulative translation adjustment component of shareholders' equity, while gains and losses resulting from foreign currency transactions are included in net income.

J. Income Taxes:

The Company accounts for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes." Deferred income taxes reflect the future tax consequences of differences between the tax bases of assets and liabilities and their financial reporting amounts at each year-end.

K. Cash Equivalents:

The Company considers investments with a maturity of less than three months to be cash equivalents.

L. Derivative Financial Instruments:

The Company uses derivative financial instruments to reduce its exposure to market risks from changes in foreign exchange rates and interest rates. The Company does not hold or issue financial instruments for speculative trading purposes. The derivative instruments used are currency forward contracts and interest rate swap agreements. These derivatives are non-leveraged and involve little complexity.

The Company monitors and controls its risk in the derivative transactions referred to above by periodically assessing the cost of replacing, at market rates, those contracts in the event of default by the counterparty. The Company believes such risk to be remote. In addition, before entering into derivative contracts, and periodically during the life of the contracts, the Company reviews the counterparty's financial condition.

ACC CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The Company enters into contracts to buy and sell foreign currencies in the future in order to protect the value of the US dollar denominated net liabilities of its foreign subsidiaries. The fair value method is used to account for these instruments. Under the fair value method, changes in fair value are recognized in the consolidated balance sheets as a component of other accrued expenses, and in the consolidated statements of operations as foreign currency gain or loss. For reporting purposes, the contractual assets or liabilities of the foreign currency agreements are offset because the agreements provide for a right of offset. Any premiums or discounts related to foreign currency contracts are amortized over the life of the contracts.

At December 31, 1997, the Company had net foreign currency contracts outstanding to buy forward the US dollar equivalent of Cdn. \$45.4 million, 15.9 million pounds sterling and DM 6.4 million. These contracts mature through May 1998.

At December 31, 1996, the Company had net foreign currency contracts outstanding to buy forward the US dollar equivalent of Cdn. \$38.4 million and 14.5 million pounds sterling.

The Company has entered into a cross-currency rate swap transaction with a financial institution which hedges the foreign currency risk associated with a portion of intercompany debt due from the Canadian subsidiary to ACC Corp. and also converts the variable rate of interest to a fixed rate. The agreement, which commenced on December 31, 1996, has a two-year term. Under the agreement, the Company pays a fixed rate of interest on a notional amount of Cdn. \$33.5 million at a rate of 6.98% and receives a variable rate of interest at the US prime rate on a notional amount of \$25.0 million. Interest is paid quarterly. The net of the notional amounts based on the exchange rate at December 31, 1997 is reflected on the balance sheet at December 31, 1997.

The Company uses interest rate swaps to effectively convert variable rate obligations to a fixed rate basis. The differentials to be received or paid under these agreements are recognized as an adjustment to interest expense related to the debt. Gains and losses on terminations of interest rate swaps are recognized when terminated in conjunction with the retirement of the associated debt. The fair value of interest rate swap agreements is estimated based on quotes from the market makers of these instruments and represents the estimated amounts that the Company would expect to receive or pay to terminate these agreements. The Company's exposure related to these interest rate swap agreements is limited to fluctuations in the interest rate. At December 31, 1997, the Company has entered into two interest rate swap agreements. The first agreement is for a notional amount of Cdn. \$19.3 million, expires March 26, 1999, and ACC Canada pays interest at a fixed rate of 4.82% and receives interest at the floating rate based on three month LIBOR. The second agreement is for a notional amount of 7.2 million pounds sterling, expires January 7, 2000, and ACC UK pays interest at a fixed rate of 7.41% and receives interest at the floating rate based on three month LIBOR. These swaps are settled every three months and the related LIBOR rates are determined at each settlement date. At December 31, 1996, the Company was not a party to any interest rate swap agreements.

ACC CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

M. Financial Instruments:

The carrying amounts of cash and cash equivalents, trade receivables, other current assets, accounts payable, and amounts included in accruals meeting the definition of a financial instrument approximate fair value because of the short-term maturity of these instruments. The carrying value and related estimated fair values for the Company's remaining financial instruments are as follows:

	December 31, 1997		December 31, 1996	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
	(amounts in 000s)			
Off balance sheet financial instruments:				
Foreign exchange forward contracts	\$ —	\$61,751	\$ —	\$52,800
Foreign currency swap agreement receivable	25,000	25,000	25,000	25,000
Foreign currency swap agreement payable	23,448	23,448	24,516	24,516
Senior credit facility and lines of credit	88,824	88,824	730	730
Capitalized lease obligation, including current portion	5,250	5,250	9,528	9,528
Interest Rate Swaps	—	12	—	—

Based on borrowing rates currently available to the Company for loans and lease agreements with similar terms and average maturities, the fair value of its debt approximates its recorded value. Foreign currency contract obligations are estimated by obtaining quotes from brokers. Interest rate swaps are estimated by obtaining quotes from the financial institution. Letters of credit and line of credit amounts are based on fees currently charged for similar arrangements.

N. Stock-Based Compensation:

In 1995, the Financial Accounting Standards Board issued SFAS No. 123, "Accounting for Stock-Based Compensation," which permits either recording the estimated value of stock-based compensation over the applicable vesting period or disclosing the unrecorded cost and the related effect on earnings per share in the notes to the financial statements. The Company has elected to comply with the disclosure provisions of the statement. The effects of SFAS No. 123 in the pro forma disclosures are not indicative of future amounts. The statement does not apply to awards prior to 1995, and additional awards are anticipated.

O. Use of Estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

P. Reclassifications:

Certain reclassifications have been made to previously reported balances for 1995 and 1996 to conform to the 1997 presentation.

2. Operating Information

Description of Business

ACC is a switch-based provider of telecommunications services in the United States, Canada, the United Kingdom and Germany. The Company primarily provides long distance telecommunications services to a

ACC CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

diversified customer base of businesses, residential customers, and educational institutions. ACC also provides local telephone service as a switch-based local exchange reseller in upstate New York and Massachusetts and as a reseller of local exchange services in Ontario and Quebec, Canada. ACC entered the German market during 1997 as a switchless reseller of long distance telecommunications services and became a switch-based provider in Germany in February 1998. ACC operates an advanced telecommunications network, consisting of ten long distance international and domestic switches located in the US, Canada, the UK and Germany, six local exchange switches located in the US, leased transmission lines, IRU's and network management systems designed to optimize traffic routing.

ACC primarily targets business customers with both local service and long distance needs, selected residential customers, and colleges and universities. For the year ended December 31, 1997, long distance revenues accounted for approximately 88% of total Company revenues, while local exchange and other revenues were 12% of total Company revenues.

At December 31, 1997, approximately \$21.8 million of the Company's telecommunications equipment was located on 65 university, college, and preparatory school campuses in the northeastern United States and in the United Kingdom. Each of these institutions has signed agreements, with original terms ranging from three to eleven years, for the provision of a variety of services by the Company.

In the United States, the Federal Communications Commission ("FCC") and relevant state Public Service Commissions ("PSCs") have the authority to regulate interstate and intrastate rates, respectively, ownership of transmission facilities, and the terms and conditions under which the Company's services are provided. Legislation that substantially revises the US Communications Act of 1934 (the "US Communications Act") was signed into law on February 8, 1996. The legislation provides specific guidelines under which the regional operating companies ("RBOCs") can provide long distance services, which will permit the RBOCs to compete with the Company in the provision of domestic and international long distance services. Further, the legislation, among other things, opens local service markets to competition from any entity (including long distance carriers such as AT&T, cable television companies, and utilities).

Because the legislation opens the Company's US markets to additional competition, particularly from the RBOCs, the Company's ability to compete could be adversely affected. Moreover, as a result of and to implement the legislation, certain federal and other governmental regulations will be amended or modified, and any such amendment or modification could have a material adverse effect on the Company's business, results of operations, and financial condition.

In Canada, services provided by ACC TelEnterprises Ltd. are subject to or affected by certain regulations of the Canadian Radio-television and Telecommunications Commission (the "CRTC"). During 1997, the CRTC issued rules that open the local telephone market to competition. It is expected that these rules will enable ACC Canada to bundle services and provide customers with local as well as long distance services in areas that are not presently open to competition.

The telecommunications services provided by ACC Long Distance UK Ltd. are subject to and affected by regulations introduced by The Office of Telecommunications, the UK telecommunications regulatory authority ("OfTel").

The German telecommunications market is expected to deregulate in January 1998, as a result of the European Union mandate to open telecommunications markets to competition. Most significantly, the Germany market is scheduled to be open for interconnection in January 1998. The telecommunications services provided by ACC Telekommunikation GmbH will be subject to and affected by regulations introduced by the German Ministry of Post and Telecommunications. During 1997, the Company received a Class 4 full voice telephony

ACC CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

license which is a requirement for the Company to become a switch-based provider of telecommunications services in Germany.

In addition to regulation, the Company is subject to other various risks in connection with the operation of its business. These risks include, among others, dependence on transmission facilities-based carriers and suppliers, price competition, and competition from larger industry participants.

Concentrations with respect to trade receivables are limited, except with respect to resellers, due to the large number of customers comprising the Company's customer base and their dispersion across many different industries and geographic regions. At December 31, 1997, approximately 26% of the Company's billed accounts receivable balance was due from resellers.

3. Debt, Lines of Credit, and Financing Arrangements

A. Debt:

The Company had the following debt outstanding as of December 31, 1997 and 1996 (amounts in 000s):

	<u>1997</u>	<u>1996</u>
Senior credit facility	\$87,824	\$ —
Working capital lines of credit	1,000	730
Capitalized lease obligations payable in total monthly installments of \$283 including interest, with rates ranging from 3.9% to 18.8%, maturing through 2002, collateralized by related equipment	5,250	9,528
	<u>\$94,074</u>	<u>\$10,258</u>
Less current maturities	(3,853)	(4,251)
	<u><u>\$90,221</u></u>	<u><u>\$ 6,007</u></u>

Maturities of debt, including capital lease obligations, are as follows at December 31, 1997:

<u>Year</u>	<u>Amount</u> (amounts in 000s)
1998	\$ 3,853
1999	1,685
2000	608
2001	33,859
2002	54,069
	<u><u>\$94,074</u></u>

B. Senior Credit Facility and Lines of Credit:

On July 21, 1995, the Company entered into an agreement for a \$35.0 million five year senior revolving credit facility with two financial institutions. Borrowings were limited individually to \$5.0 million for ACC UK and \$2.0 million for ACC US, with total borrowings for the Company limited to \$35.0 million. Initial borrowings under the agreement were used to pay down and terminate the Company's previously existing lines of credit and to pay fees related to the transaction. Subsequent borrowings were used to finance capital expenditures and to provide working capital. On January 14, 1997 this facility was amended and restated increasing the aggregate

ACC CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

commitment to \$100 million and including three additional banks in the syndicate. The amendment also allowed for borrowing in Canadian dollars and increased the sublimits individually for ACC UK to \$20.0 million, ACC US to \$15.0 million and Canada to \$30.0 million. Both the \$35 million facility and the \$100 million facility had financial and other covenants similar to those described below.

In conjunction with the closing of the \$35 million facility, the Company issued to a financial advisor warrants to purchase 45,000 shares of the Company's Class A Common Stock at an exercise price of \$10.67 per share. The warrants were exercised in October 1996.

Under the \$35 million facility, the Company was obligated to pay the financial institution an aggregate contingent interest payment based on the minimum of \$750,000 or the appreciation in value of 140,000 shares of the Company's Class A Common Stock over the 18-month period ending January 21, 1997, but not to exceed \$2.1 million. A payment of \$2.1 million was made on January 15, 1997 in conjunction with the first amendment and restatement of the credit facility, and was reflected as an accrued expense on the accompanying balance sheet at December 31, 1996.

On December 19, 1997, the Company amended and restated its credit facility increasing the amount to \$150 million. The amended credit facility is syndicated among six financial institutions. Borrowings can be made in US dollars, Canadian dollars, British pounds and German Deutsche Marks, and are limited individually to \$30.0 million for ACC Canada, \$50.0 million for ACC UK, and \$20.0 million for ACC Germany, with any unused capacity available for ACC Corp. and its US subsidiaries. The amended facility will be used to finance investments, acquisitions and capital expenditures and provide working capital. The agreement limits the amount that may be borrowed against this facility based on the Company's operating cash flow. The agreement also contains certain covenants including restrictions on the payment of dividends, maintenance of a maximum leverage ratio, minimum debt service coverage ratio, maximum fixed charge coverage ratio, and minimum net worth, all as defined under the agreement and subjective covenants. At December 31, 1997, the Company had available \$59.0 million under this facility. Borrowings under the facility are secured by certain of the Company's assets and will bear interest at either the LIBOR rate or the base rate (base rate being the greater of the prime interest rate or the federal funds rate plus 1/2%), with additional percentage points added based on a ratio of debt to operating cash flow, as defined in the agreement. The maximum aggregate commitment and the sublimits of the amended facility are required to be reduced by 8.0% per quarter commencing on March 31, 2000 until December 31, 2001, and by 9.0% per quarter commencing on March 31, 2002 until maturity of the loan in December 2002. All amounts outstanding under the amended facility may become due and payable, at the discretion of the financial institutions, upon closing of the merger with Teleport Communications Group (see Note 10, "Mergers"). The Company is currently negotiating with its lenders to obtain a waiver of this requirement.

In connection with the credit facility, the Company has entered into two interest rate swap agreements. The amended and restated \$150 million facility requires the Company to enter into hedging agreements with respect to interest rate exposure with an aggregate notional principal amount equal to 50% of the outstanding borrowings if the Company's leverage ratio is equal to or exceeds 2.0 to 1.0. The agreements have certain conditions regarding the interest rates, and must have durations of at least two years.

The weighted average interest rate during 1997 under these facilities was 6.97%. Expenses related to obtaining these agreements are being amortized over the original terms of the agreements.

At December 31, 1997, the Company had issued letters of credit totaling \$3.2 million which reduce the available balance of the credit facility. The letters of credit guarantee performance to third parties. Management does not expect any material losses to result from these off-balance sheet instruments because the Company will meet its obligations to the third parties.

ACC CORP. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

C. Working Capital Lines of Credit:

The Company has four working capital lines of credit for daily cash management, one in each of the countries in which it operates. The aggregate amount available under these facilities at December 31, 1997 was approximately \$5.2 million of which \$1.0 million was borrowed. These facilities are due on demand and are secured by a corporate guarantee or a letter of credit. The interest rates charged on these facilities are generally floating rates based on the prime rate or local equivalent in each country.

The Company had two working capital lines of credit for daily cash management in 1996. The first was a US \$1.0 million facility, due on demand, with an interest rate equal to US prime. Outstanding borrowings on this line at December 31, 1996 totaled \$730,000 and the weighted average interest expense for the year ended December 31, 1996 was 8.25%. The second line was a Cdn. \$1.0 million facility, due on demand, with an interest rate equal to Canadian prime plus ½%. There were no outstanding borrowings on this line at December 31, 1996.

4. Income Taxes

The following is a summary of the US and non-US income (loss) from operations before provision for (benefit from) income taxes and minority interest, the components of the provision for (benefit from) income taxes and deferred income taxes, and a reconciliation of the US statutory income tax rate to the effective income tax rate.

Income (loss) from operations before provision for (benefit from) income taxes and minority interest (dollars in thousands):

	<u>1997</u>	<u>1996</u>	<u>1995</u>
US	\$ 5,292	\$ 6,675	\$ 1,510
Non-US	5,575	4,184	(6,335)
	<u>\$10,867</u>	<u>\$10,859</u>	<u>\$(4,825)</u>

Provision for (benefit from) income taxes (amounts in 000s):

	<u>1997</u>	<u>1996</u>	<u>1995</u>
Current:			
US	\$ 1,797	\$2,689	\$ 581
Non-US	—	—	—
	<u>1,797</u>	<u>2,689</u>	<u>581</u>
Deferred:			
US	107	(504)	(185)
Non-US	(1,428)	—	—
	<u>(1,321)</u>	<u>(504)</u>	<u>(185)</u>
	<u>\$ 476</u>	<u>\$2,185</u>	<u>\$ 396</u>

ACC CORP. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Provision for (benefit from) deferred income taxes (amounts in 000s):

	<u>1997</u>	<u>1996</u>	<u>1995</u>
Difference between tax and book depreciation and amortization	\$ 1,457	\$ 526	\$ 772
Valuation allowance	(1,894)	98	2,223
Contingent interest	459	(459)	—
Severance costs	113	(568)	—
Software development costs	—	—	(502)
Bad debt reserve	(189)	—	—
Other temporary differences	(1,267)	(101)	(103)
Net operating loss	—	—	(2,575)
	<u>\$ (1,321)</u>	<u>\$ (504)</u>	<u>\$ (185)</u>

Reconciliation of US statutory income tax rate to effective income tax rate:

	<u>1997</u>	<u>1996</u>	<u>1995</u>
US statutory income tax rate	34.0 %	34.0 %	(34.0)%
Non-deductible goodwill and customer base	6.1	2.6	2.7
Foreign income taxes, including valuation allowance	(34.0)	(13.1)	44.6
State tax benefit	—	—	(2.4)
Other	(1.7)	(3.4)	(2.7)
Effective income tax rate	<u>4.4 %</u>	<u>20.1 %</u>	<u>8.2 %</u>

Deferred income tax assets and liabilities reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. At December 31, 1997, the Company had unused tax benefits of approximately \$4.6 million related to non-US net operating loss carryforwards totaling \$10.3 million for income tax purposes, of which \$2.5 million expire in 2000, \$4.8 million expire in 2001, \$0.9 million expire in 2002, and \$2.1 million expire in 2004. However, the Company has the ability to adjust certain depreciation and amortization adjustments in Canada which may be used to extend its ability to utilize certain net operating losses. In addition, the Company had \$9 million of deferred tax assets related to non-US temporary differences. The valuation allowance was decreased by \$4.4 million to approximately \$5.2 million to reflect tax benefits recognized during 1997. The remaining valuation allowance reflects the uncertainty of realizing the benefit of the non-US loss carryforwards and temporary differences.

ACC CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The following is a summary of the significant components of the Company's deferred tax assets and liabilities as of December 31, 1997 and 1996 (amounts in 000s):

	<u>1997</u>	<u>1996</u>
Deferred tax assets:		
Depreciation and amortization—non-US	\$ 93	\$ 967
Contingent interest	—	459
Severance costs	227	568
Other non-deductible reserves and accruals	916	528
Non-US operating loss carryforwards	4,644	6,702
Less—valuation allowance for non-US deferred tax assets ..	(3,309)	(7,669)
Net deferred tax assets	2,571	1,555
Deferred tax liabilities:		
Depreciation and amortization	(1,888)	(2,767)
	<u>\$ 683</u>	<u>\$(1,212)</u>

5. Redeemable Preferred Stock

On May 22, 1995, the Company completed a \$10.0 million private placement of 12% subordinated convertible debt to a group of investors. The notes were converted into 10,000 shares of cumulative, convertible Series A Preferred Stock on September 1, 1995. The Series A Preferred Stock had a liquidation value of \$1,000 per share, and accrued cumulative dividends, compounded on the accumulated and unpaid balance, as defined, at a rate of 12% annually. The Series A Preferred Shares were converted into 937,500 shares of Class A Common Stock at a conversion price of \$10.67 per share in October 1996. Pursuant to the terms of the Series A Preferred Stock, the cumulative dividends were forfeited, due to conversion by the investors.

The Series A Preferred Stock contained terms of mandatory redemption, on the seventh anniversary of the private placement, at a price per share equal to the greater of (i) the liquidation value of \$1,000 per share plus all accrued and unpaid dividends; or (ii) the fair market value of the underlying Class A Common Stock into which the Series A Preferred Stock was convertible.

Concurrent with the private placement, warrants to purchase 150,000 shares of the Company's Class A Common Stock were issued at an initial exercise price of \$10.67 per share. These warrants were exercised in October 1996. In addition, the Company issued warrants to purchase Class A Common Stock that were to become exercisable upon one or more optional repayments of the Series A Preferred Stock at an exercise price of \$10.67 per share, subject to adjustments, as defined, and permitted each holder to acquire initially the same number of shares of Class A Common Stock into which the Series A Preferred Stock was convertible as of the relevant repayment date. These warrants were extinguished in October 1996, as a result of the conversion of the Series A Preferred shares. Upon conversion in October 1996, unamortized issuance costs of approximately \$1.1 million were reclassified into the appropriate equity accounts.

6. Equity

During 1995, the Company's shareholders approved an amendment to the Company's Certificate of Incorporation that authorized the creation of 2,000,000 shares of Series A Preferred Stock, par value \$1.00 per share; authorized the creation of 25,000,000 shares of Class B non-voting Common Stock, par value \$.015 per share; and redesignated the 50,000,000 shares of Common Stock, par value \$.015 per share, that were previously authorized, for issuance as 50,000,000 shares of Class A Common Stock.

ACC CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

On June 14, 1996, the Company's Board of Directors authorized a three-for-two stock split in the form of a stock dividend issued on August 8, 1996 of the Company's Class A Common Stock to shareholders of record as of July 3, 1996. Share and per share amounts in the accompanying financial statements and footnotes have been adjusted for the split.

A. *Public Offerings:*

In May 1996, the Company completed a public offering of 3,018,750 shares of its Class A Common Stock at a price of \$22.50 per share. The offering raised net proceeds of \$63.1 million, after deduction of fees and expenses of approximately \$4.8 million. The net proceeds were used to reduce all indebtedness under the Company's credit facility, for working capital needs, and for capital expenditures.

In October 1996, the Company completed a public offering of 1,194,722 shares of its Class A Common Stock, on behalf of selling shareholders, at a price of \$45.00 per share. 937,500 of the shares resulted from the conversion to Class A Common Stock of all of the outstanding Series A Preferred Stock (see Note 5). Additionally, outstanding warrants and options to purchase the Company's Class A Common Stock were exercised by the holders and the underlying shares of Class A Common Stock were sold. The Company received the exercise price of the warrants and options, approximately \$2.1 million, and incurred fees and expenses of approximately \$270,000.

B. *Private Placement:*

During 1995, the Company made an offshore sale of 1,237,000 shares of its Class A Common Stock at an average price of \$9.69 per share. The sale raised net proceeds of \$11.1 million after deduction of fees and expenses of \$0.9 million. In conjunction with this transaction, warrants to purchase 123,750 shares of Class A Common Stock at an exercise price of \$9.60 per share were issued. These warrants were exercised in 1995.

C. *Stock-Based Compensation:*

The Company has four stock-based compensation plans, which are described below. The Company accounts for these plans under APB Opinion No. 25. Accordingly, no compensation cost has been recognized for incentive stock options, nonqualified stock options, and the employee stock purchase plan. Had compensation cost for the Company's stock-based compensation plans been determined based on the fair value at the grant dates for awards under those plans consistent with the method of SFAS No. 123, the Company's net income and earnings per share would have been reduced to the pro forma amounts indicated below (amounts in 000s, except per share data):

		<u>1997</u>	<u>1996</u>	<u>1995</u>
Net income (loss)	As reported	\$10,391	\$7,765	\$(5,354)
	Pro forma	\$2,866	\$4,869	\$(6,251)
Net income (loss) per share—basic ...	As reported	\$0.62	\$0.37	\$(0.52)
	Pro forma	\$0.17	\$0.17	\$(0.60)
Net income (loss) per share—diluted ..	As reported	\$0.59	\$0.34	\$(0.52)
	Pro forma	\$0.16	\$0.15	\$(0.60)

Compensation cost for stock incentive right agreements recognized in the statement of operations for the years ended December 31, 1997 and 1996 was approximately \$0.6 million and \$0.1 million respectively. Stock incentive rights issued in 1997 and 1996 were 25,000 and 30,000 respectively. The SFAS No. 123 method of accounting has not been applied to options granted prior to January 1, 1995, so the resulting pro forma compensation cost may not be representative of that to be expected in future years.

ACC CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

In connection with the merger with Teleport Communications Group Inc. ("TCG") all outstanding and unexercised options and SIRs will be converted to options and SIRs of TCG upon the closing of the merger (See Note 10, "Mergers").

Employee Long-Term Incentive Plan:

The Company has an Employee Long-Term Incentive Plan (the "Plan"), whereby options to purchase shares of Class A Common Stock may be granted to officers and key employees of the Company. In July 1995, shareholders of the Company approved an additional 750,000 shares of Class A Common Stock to be reserved for issuance under this Plan, and authorized the issuance of stock incentive rights ("SIRs") thereunder. In June 1996, the Company's shareholders approved an additional 750,000 shares for issuance under the Plan. In June 1997, the Company's shareholders approved an additional 800,000 shares for issuance under the Plan, bringing the total shares reserved for issuance to 5,300,000. The exercise price of the stock options must not be less than the market value per share at the date of grant, and no options shall be exercisable after ten years and one day from the date of grant. Options generally become exercisable on a pro-rata basis over a four-year period beginning on the date of grant and 25% on each of the three anniversary dates thereafter. SIRs represent the right to receive shares of the Company's Class A Common Stock without any cash payment to the Company, conditioned only on continued employment with the Company through a specified incentive period of at least three years. At December 31, 1997, SIRs for 55,000 shares had been awarded. 50% of the shares vest over a three-year period beginning on the date of grant, and 25% on each of the two anniversary dates thereafter.

For purposes of the pro forma disclosure above, the fair value of each option grant is estimated on the date of the grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants in 1997, 1996 and 1995:

	1997	1996	1995
Dividend yield	0%	0%	0%
Expected volatility	51%	43%	44%
Risk-free interest rate	6.04%	5.60%	7.26%
Expected life	3 years	3 years	3 years

Changes in the status of the Plan during 1997, 1996, and 1995 are summarized as follows:

	1997		1996		1995	
	Shares (000s)	Wtd. Avg Ex. Price	Shares (000s)	Wtd. Avg Ex. Price	Shares (000s)	Wtd. Avg. Ex. Price
Outstanding at beginning of year	1,598	\$ 13.97	1,606	\$ 8.81	1,178	\$ 9.02
Granted	1,095	29.99	681	14.95	512	10.23
Exercised	(573)	12.61	(588)	7.99	(50)	9.33
Forfeited	(243)	27.84	(101)	8.72	(34)	10.42
Outstanding at end of year	<u>1,877</u>	<u>21.98</u>	<u>1,598</u>	<u>13.97</u>	<u>1,606</u>	<u>8.81</u>
Number of options at end of year:						
Exercisable	617	17.00	637	12.65	608	7.94
Available for grant	843		895		725	
Weighted average fair value of options granted ..	\$12.37		\$7.09		\$3.69	